IN THE

Supreme Court of the United States

OCTOBER TERM, 1946

NOS. 674 AND 675.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

SIDNEY S. MUNTER.

COMMISSIONER OF INTERNAL REVENUE,
Petitioner,

v.

CARL MUNTER.

On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.

REPLY BRIEF FOR THE RESPONDENTS.

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The real question in the case.

The question presented in the petition for writs of certiorari (p. 2) and in the petitioner's brief (p. 2) namely, whether the "Sansome" rule applies where new stockholders acquire for cash a stock interest in the successor corporation, is not the real question in the case. The question as stated by the Government would apply where new stockholders acquired a small minority

interest. The real question is whether the payment of cash by new interests for *control* of a new corporation, formed solely to acquire the businesses of the predecessors, precludes application of the "Sansome" doctrine. Regardless of how the Circuit Court of Appeals stated its reasons, its decision was correct. That decision should be affirmed and the "Sansome" rule should not be extended to apply to a new corporation, formed solely to acquire the businesses of two existing corporations, where entirely new interests pay cash for their controlling interest in the new corporation and that cash is largely used to buy predecessor assets.

The Government's position.

The Government's position in this case is elusive. The Tax Court sustained the Government's position that the earnings of both predecessors became the earnings of the successor, *in toto*. (R. 27) The Tax Court refused to follow *Campbell v. U. S.*, 144 F (2d) 177, because of failure of proof of gain realized by shareholders who received cash. (R. 26-27) The Government argued that this holding was correct, not only before the Circuit Court of Appeals, but also in its main brief in this Court. (Petitioner's brief, pp. 25-27, especially footnote p. 25) The Government now disagrees with this holding and asks that this Court so instruct the Tax Court upon a remand. (Reply brief for the petitioner, pp. 5-6, 10-13) The Government thus adopts the argument of the respondents. (Brief for the respondents, pp. 10-11)

Up to the time of the oral argument before this Court it was the Government's position that the earn-

ings of both predecessors became the earnings of the successor, *in toto*. It was another effort by the Government to have the "Sansome" rule declared applicable to every "reorganization," as had been argued in the *Campbell* case. (Petitioner's brief, p. 31) The Government now shifts its position and argues for a remand to determine whether *part* of the earnings of the predecessors became the earnings of the successor. While so doing, it urges this Court to decide in its favor the question presented by it in the petition for certiorari. (Reply brief for petitioner, p. 5)

The main argument of the Government is based on separation into two parts (called two exceptions to the "Sansome" rule) of the reasoning of the Circuit Court of Appeals in the *Campbell* case. The Government apparently fears that the so-called "first exception" might be separately applied in some other case. The Government in effect asks this Court to reverse part of the reasoning of the Circuit Court of Appeals, torn from its setting in the facts and in the overall reasoning.

Regardless of how the Circuit Court stated its reasons, its conclusion in this case was right. The purpose of the Government would be served if this Court, in affirming the decision below, were to say that the decisions of the Circuit Court of Appeals in *Campbell v. U. S.*, 144 F (2d) 177, and in this case do not necessarily apply in every reorganization where new stockholders acquire for cash a stock interest in the successor corporation.

The case need not be remanded.

The petition for certiorari and the Government's main brief really argued that the "Sansome" rule applies to *every* transfer in reorganization, with the result that transferor earnings become transferee earnings *in toto*. (Petition, p. 7, petitioner's brief, p. 26) General application of such a rule would lead to absurdities, as clearly stated in Mertens, Vol. 1, Sec. 9.58, pp. 509, 510, as follows:

> "It has been implied, however, that the general principle of 'inherited' earnings or profits applies wherever there is a 'nontaxable' reorganization. It may be misleading, however, to state its scope in such general terms. Assuming that the provision in the statute taxing corporate distributions of 'its earnings or profits' is capable of requiring the inclusion of the earnings or profits of predecessor corporations, it would still seem to be necessary to draw distinctions based on the type and character of the reorganization in each case. Possibly a different conclusion may be applicable where there has been merely an exchange by the parent corporation of its *stock for stock* of the subsidiary in a tax-free reorganization than applies in a case in which the reorganization involves the acquisition by the new company of the old company's *assets* with other substantial changes in the corporate structure. The test should not be the 'tax-free' character of the so-called reorganization; any such general test would confuse the issue and give rise occasionally to absurd results in the various types of situations arising under our complex exchange and reorganization provisions. The proper

test is whether there is substantial identity of the several corporations and continuity of proprietary interest."

The Government, admitting that the Tax Court decision was wrong, now desires remand for determination whether *part* of the predecessor earnings became the earnings of the successor.

Respondents submit that the Circuit Court of Appeals correctly decided that no part of the earnings of the predecessors be treated as the earnings of the successor, on the grounds assigned by it (R. 42-44) and by Disney, J., in the dissenting opinion of the Tax Court (R. 27-29). The decision below is correct also for the following reasons:

(a) The 1928 transaction was not multiform, but single. Separate treatment of Henderson earnings is not justified.

(b) This is not a case of tax avoidance. The successor was a new venture by new shareholders who paid cash for their shares. Although the business of the predecessors became the business of the successor, the new corporation *purchased* the assets of the predecessors in a single transaction. The cash paid in to the new corporation by the controlling shareholders was capital. Neither this cash nor any predecessor earnings should be treated as successor earnings. Tax avoidance is not present where control shifts to new interests for cash.

(c) The "Sansome" rule disregards for tax purposes the effect of State law by treating corporate capital as earnings where transferors receive se-

curities of the transferee. Compare *Ogilvie Hardware Co. v. Commissioner,* .... U.S. ...., decided April 7, 1947. It should not be extended to apply in a situation where a new corporation is organized by new controlling interests who contribute cash which is used largely to purchase predecessor assets. Retention by predecessor shareholders of a minority interest in the new corporation formed solely to acquire the businesses of the predecessors, in a single transaction, does not justify or require application of the "Sansome" rule to any part of the earnings of either of the transferors.

(d) The 1928 transaction in this case was more in the nature of a sale to new interests than a reorganization of existing interests.

(e) The "Sansome" rule does not apply to every transfer in reorganization. Surely it would not apply where transferor shareholders holding 99% received only cash supplied by new controlling interests and shareholders holding 1% received only transferee securities. It does not apply in a case like *Campbell,* where new cash paid out exceeded transferor earnings, nor in a case like the present where new cash paid out almost equaled combined transferor earnings, the cash being supplied by new controlling interests.

The Government's argument for remand contains ill considered statements. (Reply brief for petitioner, pp. 15-17). On pages 14 and 15 of its reply brief the Government agrees with our argument that the part of the 1928 cash distribution not properly chargeable

to capital account must be considered a distribution of earnings or profits. (Brief for the respondents, p. 12)

There is however no basis for the statement, "* * * but the record further establishes that Crandall had a large paid in surplus." There is no relationship between the purchaser's valuation of the purchased assets and the capital and surplus of Crandall. The Government should know by reference to the tax returns of Crandall in its possession that Crandall did not have "a large paid in surplus." If it were a fact that Crandall did have a large paid in surplus, this fact, so important to the Government's case, should have been included in the stipulation. Moreover, regardless of the number of shareholders who receive a distribution and regardless of whether or not the distribution is pro rata, every distribution by a corporation which has earnings, to any shareholder, in excess of the amount chargeable to capital, constitutes a distribution of the earnings and profits of the distributing corporation. (Revenue Act of 1928, Sec. 115, respondents' brief pp. 24-25) After so admitting earlier in its reply, the Government's argument on pages 15 to 17 of the reply leads only to confusion and should be disregarded. The effect of a preferential distribution on dividends paid credit under later laws should not be confused with its effect on earnings and profits.

Conclusion.

The main purpose of respondents' original brief was to demonstrate that the Tax Court decision and the Government's argument for transferred earnings *in toto* were wrong. Secondarily, we met the suggestion of the dissenting Judge below for segregation and remand by showing that the Tax Court must have considered and discarded the idea of transferred earnings in part. We therefore argued for affirmance because the Government had not sustained and could not sustain its position. The Government has admitted the error of the Tax Court's and its original position. It now urges the position of the dissenting Judge.

The position now urged by the Government does not relate to the question brought before this Court, namely, whether the "Sansome" rule requires treatment of predecessor earnings as successor earnings *in toto*. Moreover, on the question of application of the "Sansome" rule to the present case, we have demonstrated that the rule should not be extended to include part of the earnings in a single transaction which is more of the nature of a sale than of a reorganization.

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SUPREME COURT OF THE UNITED STATES

Nos. 674 and 675.—October Term, 1946.

Commissioner of Internal Revenue, Petitioner,		On Writs of Certiorari to the United States Circuit Court of Appeals for the Third Circuit.
674	*v.*	
	Sidney S. Munter.	
Commissioner of Internal Revenue, Petitioner,		
675	*v.*	
	Carl Munter.	

[May 5, 1947.]

Mr. Justice Black delivered the opinion of the Court.

The Commissioner assessed deficiencies against respondents for failure to report as 1940 income dividends paid to them on stock of Crandall-McKenzie & Henderson, Inc., which respondents had bought earlier in that year.[1] These dividends are taxable as income to the respondents if the corporation paid them out of its earnings and profits. Int. Rev. Code §§ 22 (a), 115 (a), (b). Since its organization in 1928, the corporation had not accumulated earnings and profits sufficient to pay the 1940 dividend in full.[2] But the Commissioner found that the two old corporations which were merged in 1928 to form this new corporation had at that time, and turned over to the new corporation, accumulated earnings and profits suf-

[1] The Tax Court incorporated by reference a fact stipulation of the parties as its finding of fact. Each of the respondents had bought 10,000 shares of the 38,922 shares of the corporation then outstanding. The dividends declared in 1940 amounted to $35,166.25, of which each of the taxpayers received $12,500.

[2] At one point in the stipulation it was indicated that the new corporation had "no earnings and profits accumulated from December 4, 1928, to December 31, 1939," and no earnings or profits in the taxable year 1940. But elsewhere in the stipulation it appears there may have been some $32,000 earnings and profits accumulated between 1928 and 1940. The Tax Court apparently did not resolve these contradictory statements.

ficient to cover these dividends. One of these old corporations, L. Henderson & Sons, Inc., had about $75,000 in earnings and profits accumulated since 1913; the other, Crandall-McKenzie Company, had about $330,000. Liability of respondents for these deficiencies depends upon whether the new corporation acquired and retained a sufficient amount of these earnings and profits of its predecessors to cover the 1940 dividends.

The 1928 merger took place under the following circumstances. Stockholders of Henderson and certain stockholders of Crandall-McKenzie agreed together with a firm of underwriters to effect a merger of the two corporations into a new one. The underwriters agreed to buy for cash 52% of the stock of the new corporation for public sale. In execution of this agreement the new corporation was formed and acquired all the assets of Henderson and Crandall-McKenzie. The six stockholders of Henderson accepted stock in the new corporation as full payment for surrendering their old company stock. Holders of nearly one-half of the stock of old Crandall-McKenzie did not accept new corporation stock but were paid some $355,000 in cash for their old stock.[3] The other old Crandall-McKenzie stockholders were satisfied to accept only new corporation stock. When the reorganization was complete the new corporation stock had been distributed as follows: 14,607 shares to old Crandall-McKenzie stockholders, 9,524 shares to

[3] Some of the Crandall-McKenzie stockholders were paid $356.00 plus per share; others were paid $315.53 per share for identical stock.

A part of the old Crandall-McKenzie stock for which cash was paid was bought for $300,000 cash by one old Crandall-McKenzie stockholder from another while the reorganization was being transacted. The stockholder who made this purchase thereupon surrendered his original Crandall-McKenzie holdings, together with his recently purchased shares, to the new corporation in exchange for shares in the new corporation and $300,000 cash. We do not decide whether the sale from one old stockholder to another represents a transaction separate from the reorganization. Whatever may be the ultimate significance of this point, it does not affect the result we reach here.

old Henderson stockholders, and 25,869 shares to the general public through the participating underwriters.

The Tax Court found that there was a failure of proof that the earnings and profits of the old corporations had been distributed in 1928. Relying upon the rule of *Commissioner* v. *Sansome*, 60 F. 2d 931, which, for tax purposes, treats a reorganized corporation as but a continuation of its predecessors, the Tax Court determined that the new corporation acquired all the earnings and profits of its predecessors in 1928. Then, without analyzing the earnings and distribution history of the new corporation after its inception in 1928 and prior to the 1940 distribution, the Tax Court concluded that the new corporation's accumulated earnings and profits were sufficient in 1940 to make the questioned dividends taxable to respondents as income. 5 T. C. 108. The Circuit Court of Appeals for the Third Circuit reversed, 157 F. 2d 132, following its earlier decision in *Campbell* v. *United States*, 144 F. 2d 177, which had narrowly limited the *Sansome* rule. The theory of the *Campbell* decision, so far as relevant to the only question directly presented here, was that change in ownership brought about by the participation of new investors in the reorganization made the new corporation such an entirely different entity that it could not properly be called, even for tax purposes, a continuation of its predecessors.* Thus, it was concluded, earnings and profits of the predecessors were not acquired by the new corporation.

We granted certiorari because of an alleged conflict with the *Sansome* rule. — U. S. —. In the state of the record presented we find it necessary to decide no more than

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* There were two independent grounds for the decision in the *Campbell* case. One ground was that the earnings and profits of the predecessor corporation there had actually been distributed in the course of the reorganization. The Circuit Court of Appeals stated expressly that it did not rest its decision in the instant case on this theory.

whether the distinction of the *Sansome* rule made by the *Campbell* case is correct.

A basic principle of the income tax laws has long been that corporate earnings and profits should be taxed when they are distributed to the stockholders who own the distributing corporation. See Int. Rev. Code §§ 22, 115 (a), (b). The controlling revenue acts in question, however, exempt from taxation distributions of stock and money distributions, at least in part, made pursuant to a reorganization such as transpired here in 1928. See Revenue Act of 1928, § 112 (b), (c), (i) (1) (A); § 115 (c), (h), 45 Stat. 791, 816–818, 822–823. Thus unless those earnings and profits accumulated by the predecessor corporations and undistributed in this reorganization are deemed to have been acquired by the successor corporation and taxable upon distribution by it, they would escape the taxation which Congress intended. See § 112 (h), Revenue Act of 1928; *Murchison's Estate* v. *Commissioner*, 76 F. 2d 641; *United States* v. *Kauffmann*, 62 F. 2d 1045.

In *Sansome* v. *Commissioner*, *supra*, it was held that implicit in the tax exemption of reorganization distributions was the understanding that the earnings and profits so exempt were acquired by the new corporation and were taxable as income to stockholders when subsequently distributed. Congress has repeatedly expressed its approval of the so-called *Sansome* rule as a correct interpretation of the purpose of the tax laws governing reorganizations.[5] And Congress has apparently been satisfied with Treasury Regulations which follow the *Sansome* doctrine.[6]

[5] The Senate Committee recommending adoption of § 115 (h) of the Revenue Act of 1936 cited the *Sansome* case with approval. It described the new section as not changing "existing law." The Committee recommended the amendment only "in the interest of greater clarity." S. Rep. No. 2156, 74th Cong., 2d Sess. (1936) 19. See also § 115 (h) Revenue Act 1938, 52 Stat. 447; H. R. Rep. 2894, 76th Cong., 3d Sess. (1940) 41; S. Rep. 2114, 76th Cong., 3d Sess. (1940) 25.

[6] U. S. Treas. Reg. 94, Art. 115–11 (1936); U. S. Treas. Reg. 103, § 19.115–11 (1940). See *Taft* v. *Commissioner*, 304 U. S. 351, 357;

Of course, when, as in the *Sansome* case, all the stockholders of the old corporation swap all their old stock for identical proportions of the new, there can be no doubt that the earnings and profits of the old have not been distributed and are passed on to the successor corporation. But if the predecessors' earnings and profits are not distributed in the course of the reorganization, they do not disappear simply because the successor corporation has some assets and owners in addition to those of the old corporation or corporations. See *Putnam* v. *United States*, 149 F. 2d 721, 726. The congressional purpose to tax all stockholders who receive distributions of corporate earnings and profits cannot be frustrated by any reorganization which leaves earnings and profits undistributed in whole or in part. Insofar as accumulated earnings and profits have been distributed contemporaneously with the reorganization so as to become taxable to the distributees, they, of course, cannot be said to have been acquired by the successor corporation. But insofar as payments to the predecessor corporations or their stockholders do not actually represent taxable distributions of earnings and profits, those earnings and profits must be deemed to have become available for taxable distribution by the successor corporation.

It would be inappropriate for us to make the factual analysis of this record necessary to trace the earnings and profits involved in the 1928 reorganization in the absence of such a determination by the Tax Court and review by the Circuit Court of Appeals. See *Helvering* v. *Rankin*, 295 U. S. 123, 131–132; *Helvering* v. *Safe Deposit & Trust Co.*, 316 U. S. 56, 66–67; *Commissioner* v. *Scottish American Investment Co.*, 323 U. S. 119, 124. It might be that upon a full factual analysis the Tax Court would conclude that the new corporation acquired and had retained earnings and profits of Henderson sufficient to cover the 1940

Helvering v. *Winmill*, 305 U. S. 79, 83; *Douglas* v. *Commissioner*, 322 U. S. 275, 281–282; *Bochm* v. *Commissioner*, 326 U. S. 287, 291–292.

distribution. Or the Tax Court may find it necessary to make further analysis of the 1928 distributions to Crandall-McKenzie's old stockholders. In this connection it is urged that the cash paid for part of the Crandall-McKenzie stock in 1928 constituted a taxable distribution of some or all of the accumulated earnings and profits. The Tax Court, however, has previously declined to consider these cash payments as such a distribution of earnings and profits in the absence of proof that the recipients had been taxed for them. But even if it were proved that old Crandall-McKenzie stockholders had been so taxed, the face amount of that tax would not necessarily reflect the earnings and profits distribution they received. For example, part or all of their tax may have represented capital gain as distinguished from earnings and profits.[7] Or the distribution may be found to have constituted a liquidation under § 115 of the Revenue Act of 1928.[8] It may be necessary on remand, therefore, for the Tax Court to consider, in the light of §§ 112 (c) and 115 of the Revenue Act of 1928, how much, if any, of the 1928 cash distribution to Crandall-McKenzie stockholders represented earnings and profits deductible from the earnings and profits transferred to the new corporation available for the 1940 dividend payments.

The decision of the Circuit Court of Appeals is reversed with directions that the cause be remanded to the Tax Court for proceedings not inconsistent with this opinion.

So ordered.

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[7] Section 112 (c) (1) of the Revenue Act of 1928 provides in effect if a cash or property distribution is made in the course of a reorganization "then the gain, if any, to the recipient shall be recognized but in an amount not in excess of the sum of such money and the fair market value of the property." But § 112 (c) (2) makes taxable as dividend income that portion of the gain which represents the distributee's share of the distributing corporation's earnings and profits.

[8] Section 115 (c) of the Revenue Act of 1928 governs the taxability of distributions in liquidation.